

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: OCT 30 2000

Contact Person:

ID Number:

Telephone Number:

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Date

Surname

Employer Identification Number:

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were formed to operate a charter school of the deaf and hard of hearing. You will provide grades kindergarten through the 12th grade beginning [REDACTED]. The [REDACTED] school year will have [REDACTED] students of whom [REDACTED] are black, [REDACTED] Hispanic, [REDACTED] Asian, and [REDACTED] American Indian. There will be [REDACTED] faculty members of whom [REDACTED] is black. No scholarships have been awarded.

Your bylaws provide for an annual meeting of the board. Other meetings shall be held at such times as the board by resolution may require. Notice of regular meetings shall not be required. Notice of the annual meeting to be held immediately after each annual meeting of Class A members shall be given by announcement at the annual meeting of Class A members. Section 1.6 states a quorum for the transaction of business at any meeting shall consist of a majority of the board then in office. Class A member elect directors. Section 3.4 states that at all meetings of Class A members a majority of the then Class A members present or by proxy shall constitute a quorum of the Class A members for all purposes. Section 6 defines Class A members as the incorporators and/or any individual who has contributed not less than one thousand dollars in money or fair market value of property and services and affirmed by at least 70% of the then Class A members.

[REDACTED]

Your incorporators are [REDACTED] and [REDACTED] Paragraph 12 of your Articles of Incorporation states in part:

To the fullest extent not prohibited by any laws which may be applicable, . . . no director or member shall be liable to the corporation, any member or any other person or entity for monetary damage, or for any other damages, liability or obligation of any kind for breach of fiduciary duty or for any other claim, for any action taken, or for any failure to take any action, as a director or member.

Your web site address is [REDACTED] Your website includes other organizations and programs. Your website discusses the [REDACTED] FAQ About the [REDACTED] and [REDACTED] The [REDACTED] is discussed extensively. The [REDACTED] is considered a school program of the [REDACTED] Your location is the same as the [REDACTED] There is no indication that the [REDACTED] is a tax-exempt organization. [REDACTED] is listed in the organizational chart of the [REDACTED]

Your web site indicates that you are a charter school that works in conjunction with the [REDACTED] The program for the Deaf and Hard of Hearing students was adopted in the fall of [REDACTED] The two schools exist together in a cohesive environment that draws upon the strengths of each other.

Educational services will be provided by a public charter school at [REDACTED] The agreement for services and facilities between you and the [REDACTED] is for the short fiscal year beginning [REDACTED] and ending on J [REDACTED] and unless and until terminated shall continue for each succeeding twelve month period. The [REDACTED] shall furnish the following:

- A. Services of teachers and teachers' aids.
- B. Technical support services including but not limited to:
Video, computer hardware and software, Internet connections, and computer technical services for use by the applicant and its teachers and teachers' aids.
- C. Instructional, testing, and record keeping materials.
- D. Administrative, accounting, legal, consulting, tax, clerical and all other services other than those above.
- E. Use of offices, classrooms and any other real estate or

[REDACTED]

similar facilities, together with utilities, telephone, and custodial services and supplies, and use of furniture, furnishings, fixtures, equipment and similar items.


- F. Liability, casualty and other insurance and use of motor vehicles.
- G. Any other items, services or expenses that may be reasonably necessary in conducting said school.

Per the agreement you will pay a reasonable amount for such services and facilities as provided. Such amount shall be agreed upon by the parties and entered on a cost schedule as of the beginning of the school year. Paragraph 5 states all material (which term includes, but is not limited to, intellectual property, software, programs, videos, curricula, etc.) acquired or developed by the [REDACTED] remains the property of the [REDACTED]. Section 6 states that the [REDACTED] shall not be liable for damages, if any, incurred by the applicant directly or indirectly as a result of the applicant, or its teachers, teachers aids, students or other persons using any of the services and facilities furnished by the [REDACTED] to the applicant. The agreement was signed by [REDACTED] general partners representing the [REDACTED] by [REDACTED] an [REDACTED] limited partnership and limited liability partnership; and by [REDACTED] President. The cost schedule for the year ending [REDACTED], was signed by [REDACTED] a general partner, for the [REDACTED] by [REDACTED] [REDACTED] signed as President.

Your president is [REDACTED] is Vice President, Secretary, Treasurer, and Director. [REDACTED] and [REDACTED] are directors. None will receive compensation through [REDACTED] and [REDACTED] are disqualified persons as they or entities controlled by them will provide the primary facilities or services to you. They or their families own more than 35% of the combined voting power and profit interest in [REDACTED] an [REDACTED] limited liability company, and some other entities. They are the managers or control the managers of [REDACTED] and other entities. Most of the expected students and teachers are, or have been, students and teachers of [REDACTED]

Funds will be from the state and from contributions. The financial information included:

Revenue	[REDACTED]	[REDACTED]
Receipts from admissions	\$ [REDACTED]	\$ [REDACTED]
Total revenue	\$ [REDACTED]	\$ [REDACTED]



Expenses		
Salaries	\$ [REDACTED]	\$ [REDACTED]
Occupancy	\$ [REDACTED]	\$ [REDACTED]
Other *	\$ [REDACTED]	\$ [REDACTED]
Total Expenses	\$ [REDACTED]	\$ [REDACTED]

* Includes: [REDACTED] Teachers - \$ [REDACTED] Technical Services - \$ [REDACTED] curriculum development - \$ [REDACTED] Personnel - \$ [REDACTED] Tuition Reimb. Employees - \$ [REDACTED] Instructional Aids - \$ [REDACTED] District Administration \$ [REDACTED] \$School Administration - \$ [REDACTED] Technology - \$ [REDACTED] Special Ed - \$ [REDACTED] Media Center - \$ [REDACTED] [REDACTED] Teachers - \$ [REDACTED] Technical Services - \$ [REDACTED] curriculum development - \$ [REDACTED] Personnel - \$ [REDACTED] Tuition Reimb. Employees - \$ [REDACTED] Instructional Aids - \$ [REDACTED] District Administration \$ [REDACTED] \$School Administration - \$ [REDACTED] Technology - \$ [REDACTED] Special Ed - \$ [REDACTED] Media Center - \$ [REDACTED]

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for educational purposes.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(3)(i) of the regulations provides that the term "educational", as used in section 501(c)(3), relates to—

[REDACTED]

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

Section 4958(a) of the Code imposes a tax on excess benefit transactions, to be paid by any disqualified person referred to in subsection (f)(1) with respect to such transaction.

Section 4958(f)(1) of the Code defines the term "disqualified person" to mean with respect to any transaction, any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, a member of the family of such an individual, or a 35-percent controlled entity.

Rev. Rul. 76-91, 1976-1 C.B. 149, concerns the purchase, in a transaction not at arm's length, of all the assets of a profit-making hospital by a nonprofit hospital corporation at a price that includes the value of intangible assets, determined by the capitalization of excess earnings formula. The ruling concludes that the transaction does not result in the inurement of the hospital's net earnings to the benefit of any private shareholder or individual or serve a private interest precluding exemption under section 501(c)(3) because an acceptable method was used to value the assets. The revenue ruling states that where the seller controls the purchaser or there is a close relationship between the two at the time of the sale, there can be no presumption that the purchase price represents fair market value because the elements of an arm's length transaction are not present.

Rev. Rul. 76-441, 1976-2 C.B. 147, presents two situations concerning school operations. In the first scenario a nonprofit school succeeded to the assets of a for-profit school. While the former owners were employed in the new school, the board of directors was completely different. The ruling concludes that the transfer did not serve private interests. Part of that conclusion was based on the independence of the board. In the second scenario, the for-profit school converted to a nonprofit school. The former owners became the new school's directors. The former owners/new directors benefited financially from the conversion. The ruling concludes that private interests were served. The conclusion is stated as follows:

The directors were, in fact, dealing with themselves and will benefit financially from the transaction. Therefore, (the applicant) is not operated

[REDACTED]

exclusively for educational and charitable purposes and does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

Operating for the benefit of private parties constitutes a substantial nonexempt purpose. Old Dominion Box Co. v. United States, 477 F. 2d 340 (4th Cir. 1973), cert. denied 413 U.S. 910 (1973).

Leon A. Beeghly v. Commissioner, 35 T.C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest and there is a purpose to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

The petitioner in est of Hawaii, 71 T.C. 1067 (1979), conducted training, seminars and lectures in the area of intrapersonal awareness. Such activities were conducted under licensing arrangements with various for-profit corporations. The licensing agreements were conditioned on the petitioner maintaining tax exempt status. The petitioner argued that it had no commercial purpose of its own and that its payments to the for-profits were just ordinary and necessary business expenses. The Court did not agree.

To accede to petitioner's claim that it has no connection with International (the for-profit licensor of the educational program) is to ignore reality. While it may be true that the same individuals do not formally control them, International exerts considerable control over petitioner's activities. It sets the tuition for the standard training and requires a minimum number of such trainings. It requires petitioner to conduct regular seminars and to host special events. It controls the programs conducted by petitioner by providing trainers who are salaried by and responsible to EST, Inc., and it further controls petitioner's operations by providing management personnel who are paid by and responsible to EST, Inc. In short, petitioner's only function is to present to the public for a fee ideas that are owned by International with materials and trainers that are supplied and controlled by EST, Inc. Moreover, we note that petitioner's rights vis-à-vis EST, Inc., International, and PSMA are dependent on the

[REDACTED]

existence of its tax-exempt status—an element that indicates the possibility, if not the likelihood, that the for-profit corporations were trading on such status...

Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc., benefited substantially from the operation of petitioner, (Emphasis added).

In P.L.L. Scholarship v. Commissioner, 82 T.C. (1984), an organization operated bingo at a bar for the avowed purpose of raising money for scholarships. The board included the bar owners, the bar's accountant, also a director of the bar, as well as two players. The board was self-perpetuating. The Court reasoned that since the bar owners controlled the organization and appointed the organization's directors, the activities of the organization could be used to the advantage of the bar owners. The organization claimed that it was independent because there was separate accounting and no payments were going to the bar. The Court was not persuaded.

A realistic look at the operations of these two entities, however, shows that the activities of the taxpayer and the Pastime Lounge were so interrelated as to be functionally inseparable. Separate accountings of receipts and disbursements does not change that fact.

The Court went on to conclude that the organization had a substantial nonexempt purpose.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Tax Court was called on to decide whether benefits to third parties, who were not members, would prevent the organization from being recognized as an exempt organization within the meaning of section 501(c)(3) of the Code. The Court concluded that the organization could not confer substantial benefits on disinterested persons and still serve public purposes within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

Secondary benefits which advance a substantial purpose cannot be construed as incidental to the organization's exempt educational purpose. Indeed, such a construction would cloud the focus of the operational test, which probes to ascertain the purpose towards which an organization's activities are directed and not the nature of the activities themselves.

[REDACTED]

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a non-profit corporation that conducted continuing medical education tours. The petitioner had three trustees: Mr. Helin, who was a shareholder and the president of H & C Tours, a for-profit travel agency. Mr. Regan, an attorney, and a third director who was ill and did not participate. Mr. Helin served as executive director. The petitioner shared offices with H & C Tours. The petitioner used H & C Tours exclusively for all travel arrangements. The petitioner's contract with H & C Tours permitted it to acquire competitive bids, but provided that H & C Tours would always get the bid if it was within 2.5%. There is no evidence that the petitioner ever sought a competitive bid. The Court found that a substantial purpose of the petitioner was benefiting the for-profit travel agency. It concluded that:

When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) even if it furthers other exempt purposes.

We find that a substantial purpose of petitioner's operations was to increase the income of H & C Tours. H & C Tours benefits from the distribution and production of brochures, which solicit customers for tours arranged by H & C Tours. Approximately 90 percent of petitioner's total revenue for 1977 was expended on production and distribution of brochures. The terms of the Travel Service and Administrative Support Agreement further insured that H & C Tours would substantially benefit from petitioner's operations. Petitioner did not solicit competitive bids from any travel agency other than H & C Tours.

In KJ's Fund Raisers, Inc. v. Commissioner, T.C. Memo 1997-424 (1997), affirmed 82 AFTR 2d 7092 (1998), the Tax Court found that another gaming organization was not exempt. While the organization raised money for charitable purposes, it also operated for the substantial benefit of private interests. The organization's founders, Kristine Hurd and James Gould, were the sole owners of a bar, KJ's Place. The organization, through the owners and employees of KJ's Place, sold lottery tickets exclusively at KJ's Place during regular business hours. While in KJ's Place, the lottery ticket purchasers were sold beverages from the bar. The initial directors were Hurd, Gould, and a related individual. The initial board was replaced several times until Hurd and Gould were no longer on the board. At all times Hurd and Gould were the organization's officers. Salaries had been paid to Hurd and Gould and rent had been paid to KJ's Place. The organization maintained that the fact that salaries

[REDACTED]

and rent were no longer paid in this fashion indicated the independence of the board. The Court took another view.

Although those practices ceased and are not in issue here, the current board of directors is composed of at least the majority of the same members who allowed those amounts to be paid. This strongly suggests that Hurd and Gould are free to set policy for their own benefit without objection from the board. Nothing in the record since July 1, 1994, indicates otherwise.

The Court concluded that KJ's Fund Raisers was operated for substantial private benefit and did not qualify for exemption. The Court of Appeals affirmed the decision. It found that the organization had served the private interests of its directors in maintaining and augmenting their business interests.

In Redlands Surgical Services, v. Commissioner, 113 T.C. 47 (1999), the Tax Court held that a nonprofit wholly owned subsidiary of Redland Health Systems (a 501(c)(3) organization) operated for impermissible private benefit when it ceded effective control over partnership operations to private parties who had no requirement to operate exclusively for purposes described in section 501(c)(3). The organization's sole activity was participating as co-general partner with a for-profit corporation in a partnership that owned and operated an ambulatory surgery center. An affiliate of the for-profit partner was the manager of the surgical center. It received a 6% management fee under the management agreement. The court closely examined the structure of the relationships among the parties and stated:

Clearly, there is something in common between the structure of petitioner's sole activity and the nature of petitioner's purpose in engaging in it. An organization's purposes may be inferred from its manner of operations; its "activities provide a useful indicia of the organization's purpose or purposes." Living Faith, Inc. V. Commissioner, 950 F.2d 365 (7th Cir. 1991), *affd.* T.C. Memo. 1990-84. The binding commitments that petitioner has entered into and that govern its participation in the partnerships are indicative of petitioner's purposes. To the extent that petitioner cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes. In such a circumstance, we are led to the conclusion that petitioner is not operated exclusively for charitable purposes....nothing in the General Partnership agreement, or in any of the

[REDACTED]

other binding commitments relating to the operation of the Surgery Center, establishes any obligation that charitable purposes be put ahead of economic objectives in the Surgery Center's operations. The General Partnership agreement does not expressly state any mutually agreed-upon charitable purposes or objective of the partnership.

The court also looked closely at the governing arrangement of the partnership. It likened it to a board of directors. The court stated that the composition of the board of directors gives an indication of whether the organization is operated for public or private purposes. The court quoted with approval from "Income Tax Exemption of the Contemporary Nonprofit Hospital", Mancino, 32 St. Louis U.L.J. 1015, 1051 (1988).

The board of directors, its composition, and its functions are relevant to tax exemption...the composition of the board provides important evidence that the hospital serves public rather than private purposes. For example, it is fair to presume that a board of directors chosen from the community would place the interests of the community above those of either the management or the medical staff of the hospital. Thus, the relevance of the board is that its process should indicate whether the hospital is operated for the benefit of the community or to secure benefits for private interests.

After a thorough analysis of all of the operating agreements entered into by the petitioner, the court reached the following conclusions.

Based on all of the facts and circumstances, we hold that petitioner has not established that it operates exclusively for exempt purposes within the meaning of section 501(c)(3). In reaching this holding, we do not view any one factor as crucial, but we have considered these factors in their totality: The lack of any express or implied obligation of the for-profit interests involved in petitioner's sole activity to put charitable objectives ahead of non-charitable objectives; petitioner's lack of voting control over the General Partnership; petitioner's lack of other formal or informal control sufficient to insure furtherance of charitable purposes; the long-term contract giving SCA Management control over day-to-day operations as well as a profit-maximizing incentive; and the market advantages and competitive benefits secured by the SCA affiliates as the result of this arrangement with petitioner. Taken in their totality, these factors compel the conclusion that by ceding effective control over its operations to for-profit parties, petitioner impermissibly serves private interests.

[REDACTED]

In Rev. Rul. 61-170, 1961-1 C.B. 112, an association composed of professional private duty nurses and practical nurses which supported and operated a nurses' registry primarily to afford greater employment opportunities for its members was not entitled to exemption under section 501(c)(3) of the Code. Although the public received some benefit from the organization's activities, the primary benefit of these activities was to the organization's members. Rev. Rul. 61-170 can be contrasted with Rev. Rul. 65-298, 1965-2 C.B. 163. In Rev Rul. 65-298 a non-membership organization provided seminars to members of the medical profession. These seminars were designed to lessen the time between the discovery of medical knowledge and its practical application. Unlike the organization in Rev. Rul. 61-170, the benefits flowing from the activities of the medical seminar organization were of direct benefit to the general public.

Section 501(c)(3) of the Code sets forth two main tests for qualification for exempt status. An organization must be both organized and operated exclusively for purposes described in section 501(c)(3). Your Articles of Incorporation are sufficient for satisfaction of the organizational test.

You must, however, also satisfy the operational test. The regulations under section 501(c)(3) expand on the requirements for satisfaction of the operational test. The key requirement is that an organization be operated exclusively for one or more exempt purposes. To determine whether this test is satisfied, section 1.501(c)(3)-1(c)(1) of the regulations directs the Service to determine if the organization engages primarily in activities which accomplish one or more exempt purposes. Section 1.501(c)(3)-1(d)(1)(ii) of the regulations expands on the operated exclusively concept by providing that an organization is not operated exclusively to further exempt purposes unless it serves a public rather than a private interest. Based on the facts that you have provided in your application for recognition of exemption, we are not able to conclude that you are operated exclusively for public rather than private purposes.

You were incorporated to operate a school for the deaf and hard of hearing. The operation of a school in the manner you describe furthers educational purposes within the meaning of section 1.501(c)(3)-1(d)(3)(i) of the regulations. However, to satisfy the operational requirements for exemption under section 501(c)(3), you must also establish that your operations serve public rather than private purposes. If even one of your substantial activities has a private purpose, such as benefiting private parties, you will not qualify for exemption. See, Better Business Bureau, supra.

The information you submitted discloses that [REDACTED] and [REDACTED] created you. [REDACTED] and [REDACTED] are Class A members and have the

[REDACTED]

authority to appoint your Board of Directors. [REDACTED] is your President and [REDACTED] is your Vice President. [REDACTED] and [REDACTED] or entities controlled by them provide you your facilities and services. They or their families own more than 35% of the combined voting power and profit interest in [REDACTED] an [REDACTED] limited liability and some other entities. They are the managers or control the managers of the L.L.C. and other entities. You stated most of your students and teachers are, or have been students or teachers of the L.L.C.

Through [REDACTED] and [REDACTED] various positions, they completely control your activities. The management contract you entered into with the L.L.C. cedes full control of your affairs to the for-profit manager. [REDACTED] and [REDACTED] signed the Management agreement. We will discuss various provision of the management contract to determine its effect on your ability to control your charitable program: The L.L.C. shall furnish the following:

- A. Services of teachers and teachers' aids.
- B. Technical support services including but not limited to: Video, computer hardware and software, Internet connections, and computer technical services for use by the applicant and its teachers and teachers' aids.
- C. Instructional, testing, and record keeping materials.
- D. Administrative, accounting, legal, consulting, tax, clerical and all other services other than those above.
- E. Use of offices, classrooms and any other real estate or similar facilities, together with utilities, telephone, and custodial services and supplies, and use of furniture, furnishings, fixtures, equipment and similar items.
- F. Liability, casualty and other insurance and use of motor vehicles.
- G. Any other items, services or expenses that may be reasonably necessary in conducting said school.

As indicated above, the contract contains a list of services to be provided by the L.L.C. Each item is very broad. The contract is silent as to how the budget will be negotiated. For example, it does not address who will develop the budget, the time frame for development, the approval process, or procedures to handle a disagreement. The rest of the provisions are equally general. This is unusual in that a management contract should provide detailed guidance to govern the relationship between parties who are dealing at arm's-length.

Also absent from this provision and from the entire management contract is any statement about the charitable nature of the activity to be managed. There is no effort

[REDACTED]

made to establish that the manager must manage the facilities in keeping with your responsibility to continually satisfy the requirements of section 501(c)(3) of the Code. Absent any specific mention of this requirement, the manager, a for-profit corporation, has the responsibility to maximize profit.

The contract is for a twelve month period, which commences as of the opening of business on each July 1st and shall end as of the close of business on the next June 30th unless terminated. Notice of Termination must be given in April or May and effective June 30th.

The contract provides that the L.L.C. shall not be liable for damages, if any incurred by you directly or indirectly as a result of you, your teachers, teachers' aides, students or other persons using any of the services and facilities furnished by the L.L.C.

The management contract overwhelmingly favors the for-profit L.L.C. Your creator sits on your Board of Directors and controls the L.L.C., thus, we conclude that an independent board does not control you. You have entered into a contract so one-sided as to be considered an adhesion contract. These facts lead us to conclude that you were created for the substantial purpose of fostering the entry of the L.L.C. into the profitable charter school management arena. Your operations result in substantial private benefit to the L.L.C. that is not incidental to the operation of a school. In this regard, you are similar to the organizations discussed in Old Dominion Box Co., supra, and Leon A. Beeghly, supra.

The issue of private benefit has been the subject of several revenue rulings. For example, Rev. Rul. 61-170, 1961-1 C.B. 112, discusses an organization having both a charitable and non-charitable purpose. While nursing the sick was recognized as a charitable activity, the IRS determined that finding employment for nurses bestowed a substantial private benefit on the participating nurses who controlled the organization. Thus, the charitable nature of the activity was undercut by the benefits flowing to private individuals. Situation 2 of Rev. Rul. 76-441, supra, presents a fact pattern that is somewhat similar to your situation. The directors of a for-profit school converted the school to a non-profit school that they controlled. The IRS determined that the directors had structured the conversion so as to benefit themselves and ruled that the organization was not operated exclusively for exempt purposes. Rev. Rul. 76-91, 1976-1 C.B. 149, explains that the presumption of an arm's length arrangement is negated when the seller controls the purchaser. There is no rule forbidding one individual from controlling a charity and a for-profit entity. But, when the situation occurs, it is the duty of the exempt organization to act with the highest degree of fiduciary responsibility to counter the presumption.

[REDACTED]

The operation of a school is a charitable activity. However, the manner in which you have chosen to operate your school bestows significant benefits on the L.L.C. and your founders. The management contract cedes full control of your affairs to the L.L.C. and guarantees your founders and the L.L.C. compensation that does not appear to be in proportion to the services provided. The private benefit in this arrangement is intentional rather than the result of unsophisticated drafting. Your by-laws were drafted specifically to permit you to enter into contracts in which your directors and officers have a financial interest. You have entered into a contract with your creator that is not at arms-length and under the terms of which: (1) you can not control your activities to insure that they achieve exempt purposes; (2) you are not in control of your curriculum or your teaching staff so that you can not insure that you will conduct educational programs. Your Articles of Incorporation that no director or member shall be liable for damages, liabilities or obligations of any kind for breach of fiduciary duty or any other claim, for any action taken, or for any failure to take action as a director or member. Rather than establishing a high degree of fiduciary responsibility, it is clear from your submission that your Board of Directors has no power to act as a fiduciary to protect you from exploitation.

The private benefit to your founders and the L.L.C. would defeat exemption under section 501(c)(3) even if your Board of Directors were independent. est of Hawaii, 71 T.C. 1067 (1979), concerned a franchise arrangement in which the exempt organization purchased its programs and staff from for-profit entities. Although there was no structural relationship between the entities, the Court inferred from the totality of benefits flowing from the exempt organization to the for-profits that they had substantial influence over the non-profit's operations. The Court ruled that est existed for the benefit of the for-profit entities and could not be exempt. In your situation, you are providing benefits that are in excess of the benefits provided by est of Hawaii.

The Court in P.L.L. Scholarship, supra also considered the relationship between the requirements for exemption under section 501(c)(3) and the benefits flowing to noncharitable interests. P.L.L.'s Board of Directors is very similar to yours in that the creator of the organization controlled the choice of board members and the board was self-perpetuating. The Court concluded that the activities of the organization and the creator's bar where the activities took place were so intertwined as to be "functionally inseparable." Your activities and the activities of the L.L.C.'s are also "functionally inseparable." You have, in fact, ceded all of your activities, even the activities of your Board of Directors to negotiate and execute contracts, to the L.L.C.

In KJ's Fundraisers, supra, the Court also focused on the role of the Board of Directors. The organization had dropped some of its most offensive activities prior to

[REDACTED]

Court consideration. But, because the Board had initially permitted the enriching activities, the Court determined that private interests were still in control of the organization. In your case, your founders and the L.L.C., through their contractual relationship with you, have created a captive market in section 501(c)(3) schools. Because of their relationship with you, they are in a unique position to reap the benefits of the emerging commercial charter school management market.

In International Post Graduate Medical Foundation, supra, the Tax Court considered the relationship between an exempt organization and a related for-profit travel agency. The contract was written so as to exclusively favor the for-profit H & C Tours. The relationship created a captive market for the travel agency in the business generated by the exempt organization. Because of this substantial benefit, exemption was denied. Your contract with the L.L.C. is similar in that it creates a captive market of charter schools dependent upon the L.L.C.'s services.

The Court in Redlands, supra, engaged in a searching analysis of the relationship created by the petitioner's participation in the partnership agreement to support its conclusion that the organization did not qualify for exemption under section 501(c)(3) of the Code. A major factor in the Court's conclusion was that the partnership was under no obligation to conduct the surgical center as a charitable endeavor. The Court viewed the contracts entered into by the parties as useful indicia of the organization's purposes. As in Redlands, you have not required the L.L.C. to manage your activities to insure that you will continually meet the requirements for tax exempt status. Your management contract plainly demonstrates that your purposes are not exclusively charitable. The Court also discussed the importance of a public board. It felt that a community board would place the interests of the community before private interests. Your Board of Directors is selected by your Class A members (Mr. Flake and Mr. Wade). You do not have a board representative of the general public. You have, as the organization in Redlands did, ceded control to for-profit interests. See also, American Campaign Academy, supra.

Section 4958 of the Code imposes a tax liability on any individual in a position to influence an exempt organization who receives an excess benefit from that organization. If you were recognized as exempt, it is most likely that your officers and directors, as well as your manager, would be liable for tax under section 4958 because of their substantial influence over you, their manipulation of their contract negotiations with you and the excessive nature of the benefits flowing to them.

You cannot be distinguished from the [REDACTED]. Based upon your website, your activities are entwined with those of the [REDACTED]. Your facilities are the same based upon the address. You appear to be a program

[REDACTED]

designed to increase the benefits of the [REDACTED]. There is no evidence that the [REDACTED] is other than a for-profit organization.

In conclusion, your activities bestow an unearned benefit on private interests. Your founders exercise total dominion and control over your activities through their Class A membership, position of authority, and ownership interested in the for-profit organizations that own your facilities and provide you services. You have signed away your ability to insure that your activities will be conducted to achieve charitable purposes. You cannot satisfy the basic requirements for exemption, in that you fail the operational test. You are organized for private rather than public purposes within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

[REDACTED]

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
T:EO:RA:T:4 Rm. 6236
1111 Constitution Ave, N.W.
Washington, D.C. 20224

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

Enclosure:

[REDACTED]

T:EO:RA:T:4	T:EO:RA:T:4		
Initiator	Reviewer		
[REDACTED]	[REDACTED]		